



Mergers & Acquisitions Part 4

closing the deal

by Doug Cerny of Pagel, Davis & Hill

Final in a series of four articles on the preparation for and steps involved in the sale of your business.

Getting from agreement in principle to closing—the Purchase Agreement.

at a glance

- ❑ In the building components industry, buyers' key areas of focus are inventory, defective product claims, employees, and compliance with laws applicable to employees, environmental compliance and intellectual property.
- ❑ Expect the buyer's first draft of the purchase agreement to be very buyer oriented.
- ❑ When advising the seller, full and early disclosure is encouraged.
- ❑ Heavy focus and spending too much time on the indemnification can send the wrong signal to the buyer.

Previously in this series, I introduced the steps component manufacturers should anticipate when approaching the sale of a business. From the initial meeting with the prospective buyer and through the closing, it is important to remember that keeping control over the process is of utmost importance. And maintaining control means educating yourself well before you become entangled in the sale transaction.

So you have followed the steps outlined in the first few articles: you have the ownership of your company the way you want it, you have engaged advisors early in the process and have established comfortable working relationships with each of them, and you have thought about what you want out of the transaction. In this final installment of the series, let's jump to the last major hurdle in the process: the purchase agreement.

Imagine that you and the buyer have reached an agreement in principle also referred to as a letter of intent—the basic terms of the transactions—and now are preparing for the “due diligence” process in earnest.

“Due Diligence” is the title given to the investigation process conducted by the buyer to verify the financial health and status of your business. This can be quite disruptive to your business if you are not prepared for the scope and depth of the investigation.

In earnest meaning that the purchase agreement, along with the other operative documents, are being delivered by the buyer, together with the request for all of

the information on your company that will be referenced in the purchase agreement, also known as the schedules to the purchase agreement.

Now, the best piece of advice I can give when an agreement in principle has been reached: don't let up, because there's more to this transaction than price and basic terms and conditions. The provisions in the purchase agreement are important. Put yourself in the buyer's position. The buyer is most likely using someone else's money, or at least has constituents to which it is being held accountable. Whether it is shareholders, lenders or investors, the buyer likely has somebody to report to. Therefore, it will want to have rights under the purchase agreement that will allow it to produce a return on investment or at least have some recourse if there are problems. The purchase agreement is prepared by the buyer with the goal of protecting the buyer in the event your business is not as it is represented and these misrepresentations cost the buyer money.

The Basics of the Purchase Agreement

The purchase agreement will contain the following provisions:

Representations and Warranties are the “statements” made by you, the other shareholders, and possibly your company, about the status of your company. These representations are required by the buyer so that it can get a comprehensive understanding of the various aspects of your company, including the financial condition, the status of contracts, the condition of assets, etc.

Indemnification is tied to the representations and warranties made by you, the other shareholders, or possibly the company. The indemnification section requires those making the representations and warranties to compensate the buyer for any breaches in the representations and warranties or other provisions of the agreement. The indemnification provisions usually include the steps to be followed and terms of the process for resolving claims for which indemnification is sought.

Covenants are the commitments of the buyer and seller as to how they will conduct themselves, most often regarding the commitments between signing and closing, and sometimes include commitments pertaining to conduct after the closing.

Conditions to Closing are the events that must occur or things that must be in place or true prior to close in order for the buyer to complete the closing.

While not always applicable to the purchase agreement, a couple of provisions have become more common over the past several years, in particular as private equity firms have more frequently become buyers. These are escrow and right of offset provisions.

Escrow is the holding back of a portion of the purchase price, purportedly so the buyer can “take back” proceeds in the event there is a breach of representations and warranties or other provisions of the purchase agreement.

Right of Offset is the right of the buyer to draw on the escrow or to withhold payments (such as under a promissory note made payable to the seller as a result of the sale) as a result of breaches of the purchase agreement.

Note that other provisions are included when applicable. The provisions listed above and discussed in more detail in the article are the basics and most common provisions proposed by buyers.

Representations & Warranties

If the buyer had to choose one representation over all others it would relate to the seller's financial statements. The financial statements provide the buyer with a good picture of the profitability of the seller's business and a snap shot of the financial health of the seller. Some basic things for you to be aware of:

- Find out how the buyer expects/requests your financial statements to be presented and compare this to how you typically present them. The buyer will want you to represent that the financial statements have been prepared in accordance with generally accepted accounting principles (GAAP). You may be presenting them for tax minimization—which means they will not be according to GAAP.
- Know the differences between your accounting decisions and the buyer's expectations in areas of revenue recognition, expensing versus capitalizing and depreciation and capitalizing policies. Expensing your equipment purchases will yield different financial statement results from capitalizing such purchases and expensing the purchase in a smaller amount over several years.
- Avoid making representations that may relate to the company's future performance, e.g., after the closing. For instance, a representation by the seller that “the financial statements accurately reflect the results of the operations” is acceptable since it relates solely to the past. However, any representation along the lines that the financial statements “are representative of the results anticipated by the seller over the next two years” or similar is not appropriate since it is in effect a guarantee of financial results going forward.

Regarding financial statement representations, if the purchase price will include some form of payment other than cash (such as stock or a promissory note from the buyer) you will want representations as to the financial status of the buyer in order to get comfortable with the value of the stock and/or the expectation that the payment obligations under the promissory note will be made.

Continued on page 64

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Mergers & Acquisitions Part 4

Continued from page 63

In addition to the financial statements, it is common for buyers in different industries to focus on unique areas in the representations and warranties. In the structural building components industry, buyers' key areas of focus are inventory, defective product claims, employees, and compliance with laws applicable to employees, environmental compliance and intellectual property.

With respect to your inventory, the buyer wants to know that it is properly valued and does not contain obsolete or damaged materials that are not sellable. If you have not conduct-

Buyers' key areas of focus:

- ✓ inventory
- ✓ defective product claims
- ✓ employees
- ✓ compliance with laws applicable to employees
- ✓ environmental compliance
- ✓ intellectual property

ed regular physical inventories, you can expect the buyer to request that one be conducted to verify the existence and value of your raw materials.

If you have had any claims for defective products, the buyer will want to know how those were resolved. Even if you haven't had any such claims, the buyer will also want to know of any pending claims or events that may lead to a future claim. He will also want to know that you have insurance in place that is adequate in scope and amount of coverage to cover any such claims.

With all the immigration issues facing the industry, the buyer will want you to confirm that the employment of your workers and subcontractors is in compliance with the law and that the relationships with your employees is good.

In addition to the financial statements, it is common for buyers in different industries to focus on unique areas in the representations and warranties. In the structural building components industry, buyers' key areas of focus are environmental liabilities, inventory, defective product claims,

employees, and compliance with laws applicable to employees and intellectual property.

All businesses involved in manufacturing operations may have environmental issues. It is common for such facilities to be located in areas that have been used for industrial purposes for decades and operations were conducted long before the environmental rules and regulations were instituted in the 1970s and 1980s. It is also common for operations through the 1990s and even this decade to include processes that are not in compliance with environmental laws simply because the owner did not know the scope of the environmental laws. Every buyer will want an environmental assess-

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ment of your operations, also known as a Phase 1 environmental review, conducted as part of their investigation. You may want to have this conducted prior to holding any discussions so that you can be compliant and have the assessment ahead of time.

Regarding intellectual property, the buyer will want you to represent that your processes and operations do not infringe on processes owned by others and that you have the right to apply the techniques you utilize in your manufacturing operations. If you have developed unique processes the buyer will want to know that you have the documentation to show that you are the owner of those processes. The buyer will also want you to represent that your use of all software and other information technology related applications is legal and in compliance with all applicable agreements.

Expect the buyer's first draft of the purchase agreement to be very buyer oriented—this will especially be the case with respect to the representations and warranties the buyer requests. One common way for the seller to neutralize the representations and warranties is with what are referred to as a "materiality" qualifier. For example, in the representation on your relationship with your employees and compliance with employment laws, with a material qualifier you will state that you are in "material compliance" as opposed to stating you are in full compliance. Another way to accomplish this change is to state that you are in compliance *except where any non-compliance would not have a material adverse effect.*

Another qualifier that can be used is to limit portions of representations to your "knowledge." For example, regarding the representation on environmental compliance, you may want to qualify your representation to state that to your "knowl-



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edge" you are not aware of any non-compliance of environmental law. Another important point regarding knowledge is defining whose knowledge is applicable—is it you and the shareholders, or does it include your management employees? If one of your 150 employees knows something is pending, is it reasonable to expect that you should be deemed to have known about it?

Indemnification. Unless negotiated during the pricing negotiations that take place early on, the indemnification provision contained in the buyer's draft of the purchase agreement will usually start with the "seller will hold the buyer harmless from any breaches of the representations and

Continued on page 66

warranties or other provisions in the agreement.” It will be up to you to add the qualifiers: (1) a “basket,” for example, which is a de minimis amount above which the claims must exceed before the indemnification obligation applies; (2) a cap or ceiling on the aggregate amount of the indemnification claims; and (3) the period of time during which a claim must be made.

Often the lawyers for the buyer and seller will spend an inordinate amount of time on the indemnification provisions. When advising the seller, I strongly encourage full and early disclosure. Just as disclosing adverse facts late in the negotiations can cause buyers to be concerned (and often renegotiate the purchase price—downward, of course), heavy focus and spending too much time on the indemnification can send the wrong signal to the buyer—that maybe there are things being covered up. As the buyer and seller work toward closing you don’t hear about renegotiations resulting in a higher purchase price—only downward adjustments.

Covenants. In the covenants, between the signing and closing, you will be required to conduct business in the normal course, maintain relationships with customers, vendors and employees, and cooperate with the buyer and its representatives in providing information. All of these should be within your reasonable ability to control, and the standard for compliance should be reasonable or commercially reasonable and not on a best efforts basis.

Conditions to Closing. The negotiations on the conditions to closing are usually more intense than covenant negotiations. The broader and more extensive the conditions to close are, the more the transaction will feel like the buyer has an option to close and can walk if any one or more of the conditions is not met. This is particularly true when the conditions must be to the satisfaction of the buyer.

As seller you want the conditions to close to (1) be conditions over which you have control (similar to covenants) and (2) have reasonable standards for achieving them. While it may be a fact, the condition that the closing is subject to the buyer obtaining financing can leave you at the complete whim of the buyer’s efforts—reasonable or not. Likewise, a condition that the closing is subject to the buyer finding everything being acceptable to him in his discretion after “due diligence” is completed essentially leaves the buyer with an easy excuse not to complete the purchase. The conditions should be narrowly drafted and to the extent that they relate to the representations and warranties being true and correct as of the closing, they should (1) be for specific representation and warranties and/or (2) provide you with the right to update prior to closing.

Escrow and Right of Offset. The escrow provisions and, if proposed by the buyer, right of offset, need to give you rights

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so that the buyer cannot just hold back any portion of the purchase price without some form of objective standard and even the decision of a third party through mediation, arbitration or the court. While there are numerous caveats and terms that can and need to be fleshed out, as the seller you want the process to be at least balanced and objective in determining the escrow withdrawal and any rights of offset.

Summary

When you have prepared for the purchase agreement process by knowing what you want, having advisors that you are comfortable with, an understanding of the motivations of the buyer, the process of negotiating the purchase agreement and all of its terms can be exciting rather than overwhelming and distracting. You have a better chance of getting through the agreement and successfully closing at the price and along the terms originally agreed upon if:

- You disclose concerns early rather than later in the process. There is one school of thought that you get the buyer in and active and then disclose the concerns; but this often leads to renegotiations.
- You understand the buyer’s motivations in the purchase agreement and work closely with your counsel in narrowing the scope of certain representations and warranties along with the conditions and covenants so that you have control over assuring compliance.
- You keep a balanced focus on the transaction and running your business so you do not have a material slowdown in your business that gives the buyer a reason to renegotiate the price.

In the four articles that comprised this series we discussed various facets of the business sale process. From the initial discussions through the closing of the purchase agreement we have emphasized your need to be prepared and know what you want out of the transaction. A good working relationship with experienced advisors can help you keep your focus on the terms and elements of the transaction that are most important to you. Building your business has been rewarding; the process of selling your business should also be rewarding.

For a list of all terms defined within this series, visit **Support Docs** at www.sbcmag.info. **SBC**

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